<u>Ending “Too Big to Fail” – Part III</u>

By U.S. Senator Edward E. Kaufman

May 18, 2010

Mr. President, I want to praise Chairman Chris Dodd and all of my colleagues who have worked so diligently on this bill. There are many provisions in it that I strongly support.

There is one portion of the bill, however, that many of my colleagues and I have discussed on the floor extensively. And that is the question of how we prevent systemic risks from manifesting themselves among our largest Wall Street banks, those that have been deemed “too big to fail,” due to their tendency to engage in highly leveraged and extremely risky speculative trading activities.

As my colleagues know, Senator Brown and I, along with others, offered an amendment to tackle this problem directly and preemptively. The Brown-Kaufman amendment would have scaled down the size and risk of our megabanks through limits on leverage and on unstable non-deposit liabilities. While I am disappointed that the amendment did not pass, I know that the debate will persist as long as “too big to fail” banks continue to exist. For as long as we still have banks so large that they are “too big to fail,” they will pose mortal risks to the American economy.

Within days of the Senate’s consideration of Brown-Kaufman, we saw the E.U. and the I.M.F. scramble to put together an almost $1 trillion emergency package to forestall a full-blown series of sovereign debt crises throughout the continent. While ostensibly a rescue package for overleveraged and embattled sovereign nations like Greece and Spain, it was actually a bailout of Europe’s megabanks, not to mention our own. German and French banks alone have more than $900 billion in exposure to Greece and other vulnerable Euro countries, including Ireland, Portugal and Spain.

Meanwhile, our top 5 banks have an estimated $2.5 trillion in exposures to Europe.

As long as we have "too big to fail" institutions, we will continue to go through the "doomsday" cycles of booms, busts and bailouts. There are two amendments left that address this critical question, and I believe at least one of them represents a critical test of whether we as a body are serious about curbing systemic risk. While I would prefer that we pass the Cantwell-McCain amendment, which would restore the Glass-Steagall Act's 60-years-long separation between commercial and investment banking activities, I believe very strongly that – at a minimum – we must pass the Merkley-Levin amendment that would ban proprietary trading activities by commercial banks.

It is President Obama's proposal, which he has named the Volcker Rule, after the most respected bank regulator of the last half century: former Federal Reserve Chairman Paul Volcker. It has been represented to us for many weeks that even the current version of the bill includes a MANDATORY imposition of the Volcker Rule after a six month study. The Merkley-Levin amendment would remove any doubt about whether the new council could, after its review, recommend modifications to the rule.

Merkley-Levin, in my view, is where the rubber meets the road. It is the true test of whether this Administration and the Congress are serious about imposing limitations on the activities of the government-guaranteed part of our financial system – in short, so that casino-like activities can no longer remained centered at the heart of too big to fail institutions.

I also believe that a strong financial reform bill must retain the key provisions on "too big to fail" that are already in the bill, particularly Senator Lincoln's provision to prohibit banks with swap dealers from receiving emergency federal loans. This provision would help ensure financial stability by removing a government subsidy from a massive and inherently risky business.

Volcker Rule

As I said, I am proud to support Senators Merkley and Levin's amendment to include a more robust version of the Volcker Rule ban on proprietary trading within commercial banks into the bill.

Specifically, the amendment would bar banks and their affiliates from engaging in proprietary trading and from owning a hedge fund or private equity fund. To avoid regulatory arbitrage, it would also increase capital requirements on large nonbank financial institutions engaged in proprietary trading.

The Merkley-Levin amendment would minimize the potential procedural roadblocks to the Volcker Rule contained in the current bill by specifically directing the regulators to develop rules to implement the Volcker Rule restrictions. It would not give unnecessary discretion to the same regulators that have long had the authority to prohibit speculative activities at banks, but never opted to do so.

I have heard some proposals call for so-called *de minimis* exceptions and other loopholes to a ban on proprietary trading at banks. Loopholes of this kind, however, undermine the very spirit of the Volcker Rule and would allow banks that benefit from federally-insured deposits and access to the Fed window to continue to engage in activities that are purely speculative in nature.

Importantly, this amendment would also build upon the work of Senator Levin's Permanent Subcommittee on Investigations (PSI) to address conflicts of interest within the modern investment banking model. The PSI subcommittee hearings, in which I had the privilege to participate, demonstrated how Wall Street firms sold clients securities without disclosing their financial interests in seeing such securities fail or perform poorly. This amendment would address this problem by prohibiting underwriters of an asset-backed security from engaging in transactions that create material conflicts of interest with respect to the securities being sold.

I strongly urge my colleagues to support Merkley-Levin so that we can say to the American people – we have acted in Congress to prevent another crisis. I do not want to put my faith in a stability council of regulators detecting "early warning signals" of financial instability. I would rather we move our largest banks off of the San Andreas fault of leverage and speculation on which they now sit.

Glass-Steagall

I also support strongly Senators Cantwell and McCain's amendment to break up the largest banks by reimposing the Glass-Steagall Act.

Unless we break the megabanks apart, they will remain too large and interconnected for regulators effectively to control. And once the next inevitable financial crisis occurs, and the contagion spreads too quickly for the government to believe that a failing firm won't take down others as well, the American taxpayer will again be forced into the breach.

By statutorily splitting apart massive financial institutions that house both banking and securities operations, we will both cut our megabanks down to more reasonable and manageable sizes and rightfully limit government support to traditional banks. This worked for nearly 60 years, and would once again ensure the soundness of commercial banks while placing risky investment bank activities far beyond any government safety net.

If Congress fails to impose needed structural change like Glass-Steagall, the same systemic risks to our financial system will remain and grow bigger. When the next crisis occurs, however, the legislative pendulum will suddenly shift direction and it will fall hard on Wall Street in the form of Glass-Steagall and far more draconian reforms.

Swap Dealer Spin-Off

I also believe we must preserve Section 716 of the current Senate bill. That provision, included in the bill by Senate Agriculture Committee Chairman Lincoln, would prohibit banks with swap dealers from receiving emergency assistance from the Federal Reserve or FDIC.

By forcing megabanks to spin off their swap dealer into an affiliate or separate company, this section would help restore the wall between the government-guaranteed part of the financial system and those financial entities that remain free to take on greater risk.

It would also help address the enormous concentration of power among a few “too big to fail” institutions. The five largest banks – Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Citigroup, and Bank of America – control over 90 percent of the OTC derivatives market.

Yet, there are those who say that forcing these megabanks to spin off their swaps dealers to affiliates in only a few years time would disrupt the derivatives market. The historical record shows, however, that financial institutions can adapt to regulatory changes quite quickly.

Goldman Sachs has only been a bank holding company for fewer than two years. Within that time, it has used its newly formed bank, which is just one-tenth the size of the overall holding company, to source the vast majority of its derivatives transactions. Amazingly, Goldman Sachs has a $41 trillion derivatives book attached to a $91 billion bank.

Unfortunately, allowing massive derivatives dealers to be housed within banks creates moral hazard, a term often invoked by my conservative colleagues. This was true of AIG, which rented out its AAA rating and the financial strength of its insurance subsidiaries to write credit default swap contracts that systematically underpriced risk. It is also true of dealer banks, whose access to federally-insured deposits and a government backstop of emergency lending allows them to underprice risk on swap contracts. Notably, this government subsidy allows these institutions to be lax in their collateral and margin requirements on derivatives transactions.

Some complain that requiring the megabanks to spin off their derivatives dealers would require those dealers to raise extra capital as affiliates. I say that that is precisely the point.   Housing a large derivatives dealer book in a bank, even a small one, allows these institutions to arbitrage capital requirements. Requiring them to spin off their dealer to a separate broker-dealer affiliate would appropriately require them to raise more capital based upon the riskiness of their derivatives book. Currently, these institutions are undercapitalized.

Yet Federal Reserve Chairman Bernanke claims that “forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities.” I beg to differ. Spinning off large derivatives dealers would force these institutions to adequately price and capitalize the risks associated with these activities. By ending the aforementioned moral hazard, we are only strengthening financial institutions. By requiring derivatives dealers to hold capital commensurate with the risk of their business, we are only strengthening prudential regulation.

Meanwhile, FDIC Chairman Bair states that derivatives “do have legitimate and important functions as risk-management tools, and insured banks play an essential role in providing market-making functions for these products.” Requiring banks to spin off their derivatives dealers, however, would not preclude them from using derivatives as risk-management tools or as products to service client needs. For example, if a client wanted to hedge the interest rate risk on a floating rate loan through a swap, the bank would still be able to execute that transaction. Senator Lincoln’s provision doesn’t ban banks from using derivatives. Instead, it says that it is inappropriate for a commercial bank to have an almost $80 trillion derivatives book as some do.

Conclusion

Of course, anyone can come up with reasons for maintaining the status quo—of saying, for example, that Senator Lincoln’s inspired solution simply goes too far. But after the crisis we just suffered, I would ask my colleagues to support these proposals, which represent real reform and change. I would ask my colleagues to see the wisdom of building an enduring structure of laws instead of vesting our hopes in unelected regulatory discretion. We have seen the effects of regulators neglecting their duties and banks left to self-regulation.

Instead of trusting our financial stability solely to unelected financial guardians, these amendments and provisions would all address preemptively the persistent problem of "too big to fail." They all say speculative securities activities should not be covered by the government's deposit safety net. By reducing the size and scope of our largest banks, we will limit their risky behavior and minimize the possibility of one institution's failure causing an industry-wide panic and a subsequent bail-out of several failing megabanks.

By adopting these common-sense proposals, we can go a long way toward stabilizing our economy, restoring confidence in our markets and protecting the American people from a future bailout. America cannot afford another financial meltdown and the American people are looking to Congress to ensure that that does not happen. We have a precious few remaining days on this bill to follow through on that commitment.